State Notes

TOPICS OF LEGISLATIVE INTEREST

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The U.S. Financial Crisis, Federal Actions to Restore Credit Markets, and the Impact on Michigan's State and Local Governments
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The Federal government is taking some very significant and bold actions to help remedy the serious financial crisis that is gripping the national and world economies. This article provides a summary of the severity of the financial crisis, the steps being taken by the Federal government to restore the credit markets, and the impact of the financial crisis on Michigan's State and local governments.

The Financial Crisis

The financial crisis began over a year ago when the U.S. housing sector began to slow down and housing prices started to edge downward. When the decline in house values collided with the automatic upward adjustments in subprime mortgage payments, many homeowners were in the unenviable position of not being able to afford their mortgage payments and not being able to sell their house because it was worth less than their outstanding mortgage. As a result, home foreclosures began to rise and the balance sheets of banks and other financial institutions that held these subprime mortgages began to deteriorate. By the summer of 2008, it became apparent that the breadth and scope of the problems these subprime mortgage defaults and foreclosures were placing on the financial sector were much worse than anyone had suspected.

Over the past month, the financial crisis escalated into the most serious financial problem the U.S. has faced since the Great Depression in the 1930s. Initially, the Federal government addressed problems facing individual financial institutions as they arose. These ad hoc targeted actions by the Federal government included taking over Fannie Mae and Freddie Mac, crafting special loans for American International Group (AIG), and changing rules so Goldman Sachs and other investment banks could survive by restructuring into commercial banks. At the same time, some financial institutions, including Washington Mutual and Lehman Brothers, fell into bankruptcy. While these moves by the Federal government were intended to help restore more normal operations in the financial sector, the steady stream of bad news about key financial institutions actually caused confidence in the system to plummet. As a result, banks stopped lending to other banks, loans to businesses essentially stopped, the stock market fell by historical amounts, investors pulled their money out of mutual funds, and the demand for the very safe Treasury bills rose dramatically.

Emergency Economic Stimulus Act of 2008

Due to this snowballing of the financial crisis in just the past few weeks, the Federal government decided broader and bolder actions were needed to avoid a complete collapse of the financial markets. As a result, the U.S. Treasury Department proposed a broad plan to help rescue the financial sector. This plan, called the Emergency Economic Stimulus Act of 2008, was modified and approved by Congress and signed into law by the President on October 6, 2008. The main component of this new Act is the Troubled Asset Relief Program (TARP), which gives the Secretary of the Treasury the authority to purchase, insure, hold, and sell a variety of troubled financial securities, including mortgage-backed financial assets. Under TARP, the Federal government will purchase mortgage-related assets and other troubled securities to help improve the financial well-being of banks and other financial institutions. The U.S. government will hold these assets and sell them at some future time when their value, one hopes, has improved.

In addition, the Treasury Department will inject funds directly into the banking system by purchasing ownership in banks. Through the TARP Capital Purchase Program, the Treasury Department will buy up to $250.0 billion of preferred shares in qualified financial institutions that register to participate by November 14, 2008. These bank ownership shares will be held temporarily by the Treasury Department and then eventually sold once the financial institution reestablishes a solid financial position. Nine major banks already have registered for this program.

The law limits the total amount of troubled assets and bank shares the Federal government may own at any time to $700.0 billion. This limit applies to the Federal government's gross purchases of these assets less any receipts acquired by selling them. This overall $700.0 billion limit has three sequential thresholds:

1. Initially, the U.S. Treasury Department has the authority to purchase financial assets totaling $250.0 billion.

2. The limit on these purchases may increase to $350.0 billion, if needed, but the President must notify Congress in writing that it is necessary to increase the limit an additional $100.0 billion.

3. The limit may be increased by another $350.0 billion, up to a total of $700.0 billion, but only if the President submits to Congress a report detailing why the limit needs to be increased; then Congress will have 15 days to disapprove the request. If no Congressional action is taken during this 15-day period, the increase in the limit will automatically go into effect.

This plan will not cost taxpayers $700.0 billion because the assets that will be purchased by the Federal government will have value and eventually will be sold. The big issue is the same as the one that the banks and other financial institutions are currently grappling with - how much these assets are currently worth and how much they can be sold for in the near future.

The other major components of the Emergency Economic Stimulus Act of 2008 include:

- Deposit Insurance Increase. The Federal Deposit Insurance Corporation (FDIC) will temporarily increase the maximum amount per account that is insured by the Federal government. Currently, the FDIC insures accounts up to $100,000 and this has been increased to $250,000 through December 31, 2009.

- Recoupment of Losses. The President will be required to propose to Congress a plan to eliminate any net loss (gross purchases less revenue from sales) under TARP if such a net loss exists at the end of five years.

- Executive Officer Compensation. Any financial institution that sells at least $300.0 million of troubled assets to the Federal government will not be able to deduct as a business expense for Federal tax purposes compensation paid in excess of $500,000 to each of its five highest-paid executives or certain "golden parachute" payments to these executives. Restrictions on executive compensation also will apply to banks that participate in the TARP Capital Purchase Program.

- Interest on Bank Reserves. Banks are required to maintain a certain level of reserves at all times to ensure that the banks have sufficient funds available to cover withdrawals by depositors. These reserves must be held in cash and may not be invested. This law allows the Federal Reserve to pay interest on the required reserves held by banks and thus help increase the funds available for banks to lend.

- Assistance to Homeowners. The U.S. Treasury Department is required to provide guidance to homeowners and prospective homeowners by promoting such programs as the Hope for Homeowners Program, which was created in the National Housing Act. In addition, the Federal Housing Finance Agency, the FDIC, and the Federal Reserve Board are directed to implement appropriate measures to help reduce the number of foreclosures on residential loans and other related securities that are under their control. These measures could include restructuring mortgages by extending the term and thus reducing the monthly payment.

The U.S. Department of Treasury is currently in the process of implementing the provisions of the Emergency Economic Stimulus Act of 2008 and it hopes to start buying bank shares in the next week or two and begin purchasing troubled securities in the latter half of November.

Other Actions Taken by the Federal Government

In addition to enacting the Emergency Economic Stimulus Act of 2008, the Federal government recently has taken and is taking other actions to help bring relief to the financial markets. All of these actions are designed to add liquidity and confidence to the financial markets and make credit readily available once again. These actions include:

- The Federal Reserve lowered the Federal Funds rate from 2.0% to 1.5%. The Federal Funds rate is the rate banks charge on very short-term loans made to other banks.

- The Federal Reserve will begin making short-term loans to businesses to help make up for the recent collapse of the commercial paper market, which is the market that many businesses use to borrow funds when their cash flow is insufficient to cover such costs as payroll and purchases of supplies.

- The Federal Reserve will auction loans to banks totaling $900.0 billion between now and the end of 2008.

Impact of the Financial Crisis on Michigan Government

The severe national financial crisis is having negative repercussions on overall economic activity, interest rates, availability of credit, and consumer and business confidence. These negative factors not only will have a negative impact on Michigan's economic performance, but also will have some negative repercussions on State and local governments. The major likely negative impacts on government include the following:

Tax Revenue. The most significant ill effect from the national financial crisis on State and local governments likely will be a decrease in tax collections. Credit is a key component of the day-to-day operations of the economy, including borrowing by consumers to purchase motor vehicles and other durable goods, short-term borrowing by businesses to help smooth cash-flow shortfalls or invest in new equipment, and borrowing by State and local governments. As the availability of credit diminishes, consumers, businesses, and governments are forced to curtail spending, and this will slow economic activity and lower State revenue derived from taxes, including the income, sales, and business taxes. In addition, a weaker economic climate will have negative repercussions on property values and therefore on property taxes, which are the main source of income for local governments.

Short-Term Borrowing. State government typically borrows over $1.0 billion at the beginning of a fiscal year to help improve its cash position and then repays the money at the end of the fiscal year. At this time, it is not known if short-term credit will be available to State government, but even if it is, the cost to borrow the money will be higher than it otherwise would be, given the credit crunch. The Michigan Department of Treasury will have to factor in the availability of credit and its cost against the need to borrow funds to help smooth out the State's cash-flow position.

Capital Outlay Borrowing. The availability and cost of selling long-term bonds for capital improvements for both State and local governments may force the delay of some projects or at a minimum increase the cost to finance them.

Pension Funds and Contribution Rates. As the stock market has tumbled, the value of Michigan's pension funds has declined by several billion dollars. This decline in the value of the pension funds will push up the pension contribution rates that will have to be paid for public school employees participating in the Public School Employees Retirement System and State government workers who are in the defined benefit pension plan.

Revised Economic and Revenue Projections

While the breadth and depth of the financial crisis and its repercussions throughout the economy are still playing out, it is clear that economic activity will be slower than had been projected previously and tax revenue will be less than previously estimated. The Senate Fiscal Agency will continue to closely monitor the financial crisis and its current impact and potential future impact on overall economic activity and revenue collections. The Agency then will use these findings and information to prepare a new economic forecast and new revenue estimates, which are currently scheduled to be released in the middle of December.